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"The American debt situation and the American bank epidemics are in a class by themselves. Given the way in which both firms and households had run into debt during the twenties, it is clear that the accumulated load was instrumental in precipitating depression. In particular, it set into motion a vicious spiral within which everybody's efforts to reduce that load only availed to increase it.

Business Cycles, J.A. Schumpeter p.909
McGraw-Hill Book Co., New York, 1939

HIGHLIGHTS

The U.S. dollar has fallen 22% from year-ago levels by simple force of poor fundamentals. Speculators have yet to play a significant role.

The purchasing power parity theory (PPP) remains the last stand for the dollar-bulls. We sharply disagree with their view for many reasons. Practicably speaking, the PPP has never proven to be a reliable forecasting tool anyway.

In America, economic weakness has spread everywhere. The American consumer is becoming exhausted and businesses are in even worse shape. Recent GNP revisions confirm what we have suspected all along: the economy has been sharply weaker than most have expected.

A number of populist theories still hold that a U.S. recession is unlikely . . . notable among these being that there are no inventory excesses. It's a strikingly simplistic theory and shows a frighteningly poor understanding of the complex underlying forces that are inexorably driving deficit economies into inevitable recession.

The imbalances propelling the deficit economies into recession have a far more vicious nature, these being under-investment, under-saving, and over-indebtedness - nearly all of it for unproductive purposes.

In the U.S., the fact is that the incipient recession will be caused by numerous deep-seated imbalances and maladjustments caused by the worst credit-inflation that has ever been experienced in the whole post-war period. This downturn will be far more difficult to combat than ever before.

What we see in the United States is not a credit contraction at all. Believe it or not, relative to GNP growth, credit is expanding at the most rapid pace of the entire post-war period.

In our view, the U.S. dollar and the other currencies in its orb are destined for a steep fall. To this point the tumble has only begun.

THE UNITED STATES: FROM BOOM TO BUST

The destructiveness of an earthquake depends not only on the strength of the shock but also on the structural integrity of the buildings nearer its epicentre. What happened in the financial markets after Iraq's invasion of Kuwait has probably more to do with the shakiness of financial markets than with the importance of the military event as such.

Nevertheless, the decisive questions for financial and currency markets remain the same as before the invasion: first, the precariousness of the U.S. economy and its financial system; and second, the response of U.S. monetary policy to an economic and financial crisis.

Despite the many questions, the fact of the matter is this: against all expectations the U.S. dollar has fallen 22% since a year ago. Then, when the dollar was at DM 2.00 to 2.05, markets were abuzz with forecasts of a further spurt to as high as DM 2.40. Now, the dollar limps well below DM 1.60 (last seen at DM 1.5775 as we write.)

Such a sharp drop and yet, what is today's market perception? Again and again as we talk with numerous traders and institutional investors the same sentiment comes through: an undertone of unconcern. Obviously, the sharp fall through DM 1.63 and DM 1.60 took many people completely by surprise although it didn't trigger any great alarm. One has the impression that the dollar-fall was met with more disbelief than anything else. There surely are few who expect a prolonged fall in the dollar. From our anecdotal evidence we are pretty sure that most traders and international investors completely missed the fall of the dollar. As markets climb a wall of worry, it seems the dollar has fallen down a ladder of hope.

Recently, we spoke at the world gold conference in Venice sponsored by the Financial Times. In more than 20 speeches the question of the dollar exchange rate - not to mention the prospect of a dollar crisis - was never mentioned except by ourselves. The clearest market evidence of this sentiment - although one in antithesis - was the panic selling of D-mark bonds by foreign investors earlier in the year.

It has been the constant theme of this letter that the dollar's fundamentals - both internally and externally - have never been so negative in the entire post-war period as presently. On the flip-side, the German economy is in its best shape of several decades. We have always taken pains to point out that the changes in both countries are not simply of cyclical origin but rather are of secular character. For reasons explained in our last letter, America's long-term growth potential is down sharply while Germany's has risen.

Dollar Complacency. Yet, there is some mysterious underlying optimism about the U.S. economy and the dollar although no one seems to be able to articulate a strong fundamental case . . . vague ideas about the invincibility of the world's largest economy, yes, but no fundamentals. We often ask ourselves why there should be this optimism on the U.S. economy and its currency. In fact, pro-dollar sentiment even seems to be more pronounced in Europe. Strikingly, the dollar weakens in America after European markets have closed and always seems to recover after morning reopening in Europe.

Again recently, it was typical how the dollar shot up quickly in Europe (from DM 1.59 to DM 1.62) on the news of the Iraqi invasion of Kuwait. It made absolutely no sense. If this invasion were to cause economic and political problems for any industrial country, it would surely be for

the United States. Just as typically, the U.S. markets promptly hammered the dollar down again.

Apart from myth and fancy, we identify two supporting theories for dollar optimism: firstly, the purchasing power theory which holds that the dollar is grossly undervalued in its domestic purchasing power relative to other currencies; and secondly, the idea that the dollar tends to strengthen when the U.S. economy weakens because it improves the trade account and pulls in foreign portfolio investment on the prospect of capital gains due to falling interest rates.

Understandably, the purchasing power theory has become the great darling of the incurable dollar-bulls because there is nothing else left from which they can draw comfort. Quoting one of bulls that happens to enjoy great market esteem internationally: "*Relative to purchasing power-parity (PPP), the dollar is substantially undervalued, perhaps by 20-30%. . . . the dollar is cheap stock. If it falls more, then, in equity market parlance, it will be even cheaper and implicitly more attractive to long-term investors.*"

While not every dollar-bull may be this emphatic, there is a general vague perception that the dollar cheapness in terms of "purchasing power" is at least providing substantial down-side protection.

In past letters we have often pointed out the flaws of the above two pro-dollar theories and risk belabouring our readers if we were to repeat them. But, since the purchasing-power argument has gained such strong persuasion in present market thinking, we must briefly hurl a few more arguments.

PURCHASING PRICE PARITY: A MISLEADING THEORY.

For a start, the PPP has been almost worthless in determining the course of exchange rates in the past. In any case, we find it simply grotesque to speak of an over-valued D-mark and a cheap dollar when Germany has the world's biggest current-account surplus and the U.S. boasts the world's largest deficit. What better indication could there be as to the relative competitiveness of the tradable goods sectors of these two countries?

Here is a particularly positive feature of the German export picture: exports account for more that 25% of German GNP and are spread widely over a broad range of products and countries. Actually, 72.5% of Germany's exports are made to European countries. Only 7.3% of these exports go to the United States.

This wide dispersion of German exports is surely the best evidence of general competitiveness. Most importantly, however, it makes the German economy less vulnerable to a coming U.S. recession.

In this respect, we would like to draw a striking contrast to Japan. Its exports - representing only 9% of GNP - are pointedly concentrated both by major market and product line. For example, 34.3% of Japan's total exports are destined for the United States, accounting for 55% of its trade surplus. What's more, Japan's exports are heavily centred on four products: automobiles,

communications equipment, electrical appliances, and office machines (which together account for 55% of all Japanese exports.)

Germany's business strength - particularly in comparison to America and Japan - lies in the many thousands of small and medium-sized companies that offer a great variety of high-quality products to even the smallest of markets.

An important point, however, which the purchasing power theory entirely neglects is that before a country can export successfully it first needs the capacity to deliver tradable goods. That capacity, in turn, depends on the investment ratio in manufacturing. In this respect, the difference between the United States and Germany is truly colossal.

In the United States during the 1980s, net investment in business plant and equipment was at its lowest of the post-war period, having been near zero. This anaemic investment performance finds its root in extremely weak business profits. Even though a recession hasn't started yet officially, business profits have already fallen to 5.4% of GNP. That compares dismally with the lowest point since World War II of 4.5% of GNP during the worst months of the 1982 recession.

Contrastingly, in Germany the net investment ratio of the production sector is up sharply from 1.5% of net national product in 1982 to 5.7% in 1989. Business profits have also risen strongly and are up from 18% to 26% of net national product over the same comparison period. That's a record level last attained in the early 1970s.

If the D-mark were truly overvalued, such a robust profit and investment performance would not be possible. Conversely, the flagging U.S. investment and profit performance couldn't better confirm that the dollar is overvalued.

JULY 27TH - THE SHOCKING REVISION

Back to the question of whether or not the U.S. economy is sliding into a deep and lengthy recession. It's certainly no secret that this letter has long maintained that the U.S. economy is a lot weaker than most observers have thought. Now, our viewpoint has been fully confirmed by the statistical revisions of the Commerce Department's announcements on July 27th - an event which we forewarned of in the last issue. The downward adjustments contained in this report were truly monumental.

The crucial point that these revisions reveal is that the economic downturn actually began in March 1989 . . . which, if you remember, was about the approximate time when markets ran scared of a new upturn in economic growth and inflation. The Fed then pushed up the Fed Funds rate to nearly 10%; which sent the dollar soaring. In reality, as the numbers show, it was the start of a slow but progressive weakening of the economy right across the whole spectrum. The revised figures shown in Table 1 need no comment.

If these figures don't show a persistent, distinct downtrend across the board, we can only wonder

what does. Of notable importance is the sharp loss in export momentum given the fact that exports have been the chief motor of the expansion for the past 30 months.

REAL GROSS NATIONAL PRODUCT
(Percent Change from Year-ago Quarter)

	I89	II89	III89	IV89	I90	II90
GNP	3.2	2.7	2.4	1.8	1.3	1.2
Personal Consumpt'n	2.3	2.0	2.3	1.2	1.5	1.1
Non-res. Fixed Investment	4.7	2.6	3.8	4.5	3.5	0.2
Residential Investment	0.7	-3.8	-5.8	-7.1	-2.8	-3.5
Exports	10.4	12.5	10.9	10.1	9.0	4.9
Government Spending	2.7	2.9	3.2	0.3	1.9	2.4

Closer scrutiny, in fact, shows that the recent expansion which started in the third quarter of 1987, being shortly before the stock market crash of 1987, already peaked in the first quarter of 1988. In that quarter, real GNP was up 5% against a year ago, personal consumption was up 3.8%, nonresidential fixed investment, 10.1%, and exports, 24.6%. Since then, growth rates have steadily declined led by weakening exports and investment.

Until quite recently, it was Wall Street's favourite slogan that high employment and income growth in the service sector would keep the economy on a perpetual roll. Well, the statistical revisions have virtually pounded this argument into oblivion. Real disposable income growth in 1989 happened to be revised down from 4.0% to 2.4%. That's a magnitude change of no less than 40%. Meanwhile, in the first half of 1990, income growth has fallen further to an annual pace of 1.5%.

WEAKNESS ALL OVER

Weakness has spread everywhere. Consumer confidence is slipping badly. According to the Conference Board Survey, the latest reading stands 15% below the level reached in July 1989. The growth rate for private employment has sagged from 3.1% in the second half of 1988 to 1.5 % in the first half of 1990. Retail sales, adjusted for inflation, have declined by 4% since September 1989. Housing starts and permits have dropped to their lowest levels since November of 1982 - having fallen from a height of 1.7 million starts in early 1989 to 1.2 million. Along with the extremely weak new housing condition, real estate seems to be slumping in most parts of the U.S..

If the American consumer is in very bad shape financially, businesses are even worse. Profits, cash flow and investment are all down sharply, while debts are up. U.S. corporations have piled up record debts - not for purposes of investment in tangible or financial assets - but to buy back their own shares. Meanwhile, as profit margins are squeezed by sluggish sales and soaring debt service, dividends have been boosted at the expense of retained earnings. Many corporations have systematically destroyed their capital base in these ways.

The rise in interest costs is truly dramatic. During the 1950s and 1960s it took on average 16 cents of every dollar of pre-tax (and pre-interest) earnings to cover corporate interest costs. The corresponding average for the 1970s was 33 cents. Since 1980, however, the figure has risen to 56 cents. In fact, during the last decade interest costs have remained above 50% of every pre-tax dollar of corporate income.

The most critical aspect of the corporate debt build-up may not be the totality of all debt, even though it has risen to $3.5 trillion from $1.3 trillion during the 1980s. A more serious problem lies in the unequal distribution among debtors.

This profit squeeze is particularly ominous for two reasons: <u>first</u>, it is occurring well before a recession has commenced; and <u>second</u>, the decline started from a level that was already relatively low. As we have repeatedly stressed, this past expansion of the U.S. economy has been a profitless prosperity all along. The key cause can be found in a grim productivity performance that has been magnified by a relentless rise in interest costs. Poor productivity growth boosts unit labour costs while strong competitive pressures limit the ability of the companies to push through compensating price increases.

NO PROSPECT OF FAST RECOVERY

Now, after the recent revision of the GNP and income data, even the optimists admit that the economy is skirting with recession. Yet, we still have the impression that there is no real sense of alarm. Most observers remain convinced that all that's needed is a modicum of easing by the Fed and the patient will again be cured instantly.

Why this continued complacency? We think this unconcern is born of the experience of the long unbroken economic recovery over the past 7-8 years. Various populist theories have sprouted explaining that the U.S. economy has become recession-proof and if there were to be any recession, it would be mild and brief because the U.S. economy is highly responsive to small changes in interest rates. The accompaniment to this view, of course, is a necessary blind faith in the Fed's ability to fine-tune the economy.

Best-known of the populist theories are the following three: <u>first</u>, the rolling recession scenario; <u>second</u>, that the ever-growing GNP-share of the service sector (which is regarded as non-cyclical) makes the economy impervious to recession; and <u>thirdly</u>, the absence of inventory excesses.

The theory that has the most nods is the inventory argument. Even Greenspan has mentioned that the danger of a recession is small because inventories are well under control. In the case of Canada, the chief economist of its statistical agency had even gone so far as to conclude that a recession is virtually impossible because the inventory-sales ratio is low.

It's a strikingly simplistic theory. To us, though, it shows a frightening lack of understanding of the complex underlying forces that are inexorably driving the economies of the deficit countries into deep and prolonged recessions.

It is true, though, that all past North American recessions in the post-war period were mainly due to an overaccumulation of inventories. These were associated with sharply accelerating inflation, drastic monetary tightening and sharply higher interest rates. This time, none of these familiar harbingers of past recessions is present. Inventories seem to be under control, inflation appears steady even though high, and monetary policy has already eased and paved the way for lower interest rates. Consequently, - so goes the widespread conclusion of comfort - recession is improbable, if not impossible.

DEEPER-SEATED REASONS FOR RECESSION

If the United States, Britain, Australia, Canada, and some others, had no other problem than excessive inventories they could congratulate themselves. Unfortunately, their economies are plagued by a dozen other problems and imbalances that are far worse than inventory excesses.

Inventory recessions have three characteristics. They are sharp, brief and - what's critically important - self-correcting. Demand and production drop drastically, but the liquidation of stocks and debts proceeds rapidly. Once the inventory liquidation ceases, demand and production take-off again.

Wall Street anticipates that a recession will trigger a sharp decline in short and long-term interest rates which in turn will quickly re-stimulate the economy as per the script of past recoveries. It is poorly understood that this V-shaped scenario is precisely and exclusively the characteristic of an inventory liquidation: a burst of debt liquidation, a drastic monetary easing, and a rush of investors and savers from short-term deposits into longer-term securities.

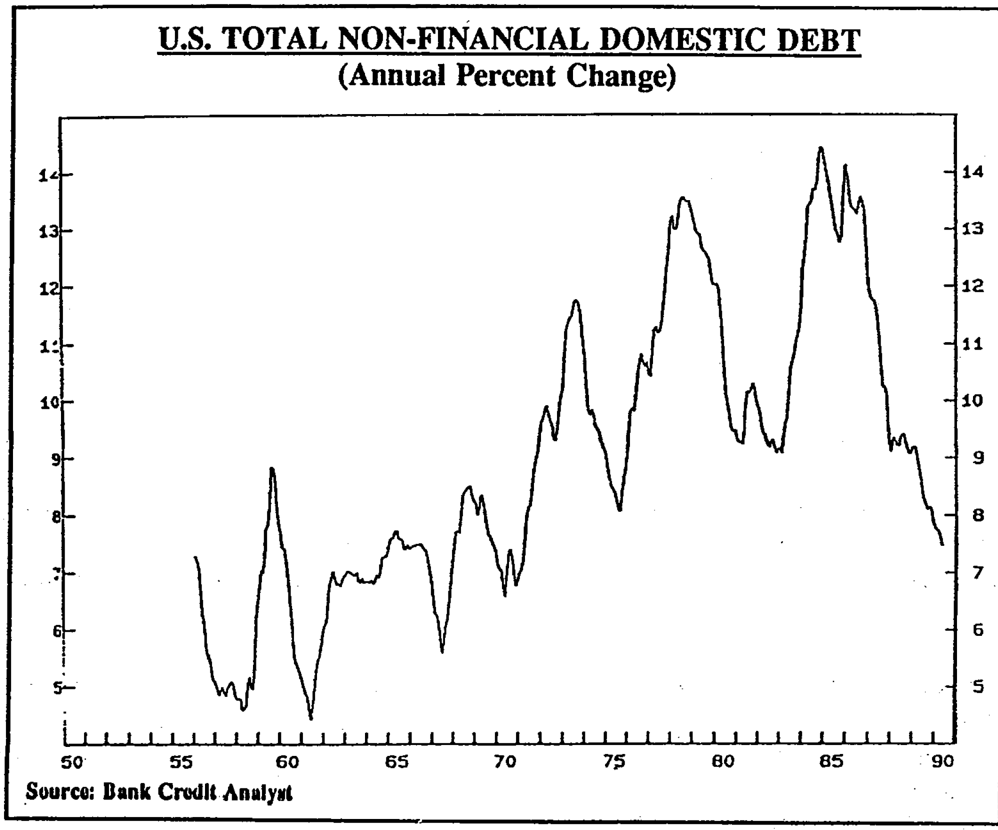
It has been a consistent theme of these letters that the next recession gripping the U.S. economy will be diametrically different. We expect it to be far more prolonged and severe than all other post-war recessions. This time, the causes and problems go far deeper than a mere cyclical inventory recession. The excesses, maladjustments and malinvestments generated in the course of the past boom are unprecedented in their magnitude and have exhausted the economy with years of over-borrowing and over-spending.

CAUSES OF THE IMPENDING RECESSION

Exactly what is it that is propelling the U.S. economy into recession? Is it tight money or something else? For an answer, simply revisit the gross national production figures in Table 1 on page 5. As we've already pointed out, every single component of final demand shows a progressive weakening.

Most economists attribute the erstwhile slowdown to more familiar causes: overly tight money and a credit crunch that are strangling demand growth. Therefore follows the idea that the remedy for an ailing economy is easier money, easier credit and lower interest rates.

A heated dispute has arisen about the exact state of monetary conditions in the United States. There is increasing talk of "contracting" credit and liquidity which gives the impression that the



United States has the tightest monetary conditions in the world. Last, but not least, this perception of monetary tightness is also one of the arguments supporting the expectation of a strong dollar.

What Kind of Credit Contraction?

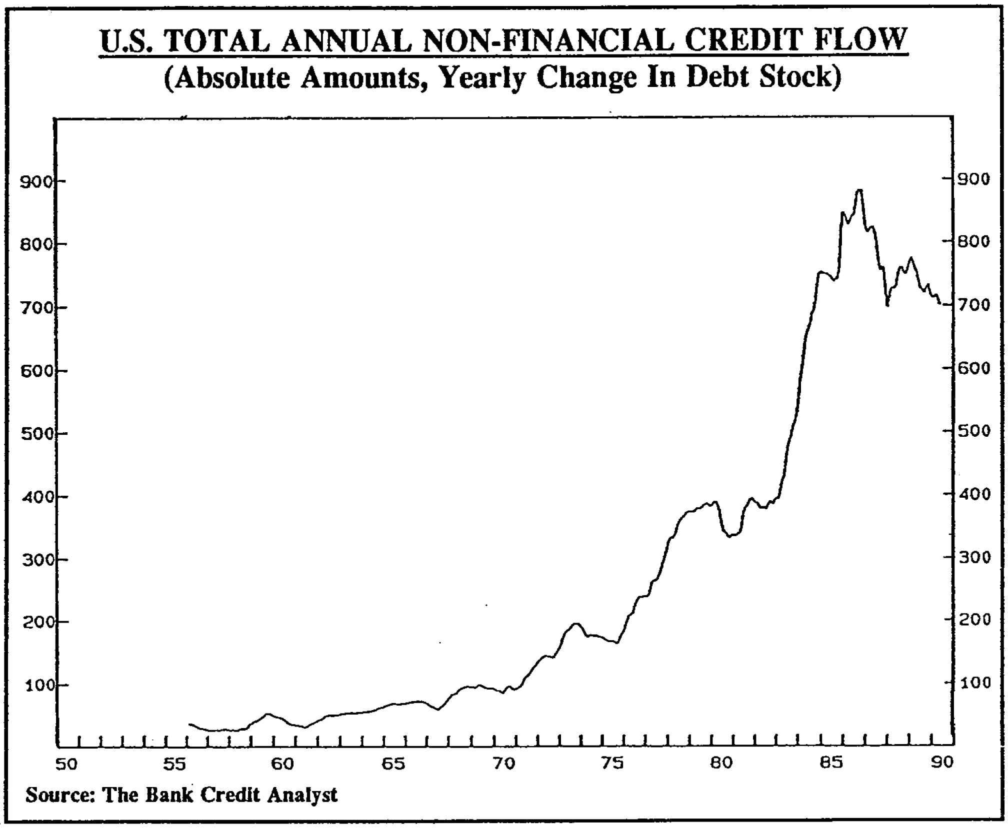
What we see in the United States is not a credit contraction at all. On the contrary, what we continue to see is a continuing runaway credit expansion. During the first quarter of this year, total credit (public and private) grew at an annual rate of $771 billion. Such a level of credit expansion has been surpassed only twice before: in 1985 ($846 billion) and 1986 ($831 billion).

Believe it or not, relative to the overall growth of the economy, credit is expanding at the most rapid pace of the entire post-war period. Nominal GNP grew at an annual rate of $332 billion in the first quarter while, as we already pointed out, credit leaped $771 billion on the same basis. That means each dollar of additional GNP required $2.30 of new debt. The obvious problem is that a credit expansion becomes less and less effective.

How does that compare with past GNP/debt ratios? For the entire post-war period up to the end of the 1970s, the ratio of non-financial debt to GNP fluctuated with the business cycle around an average of $1.36 of debt for each incremental dollar of GNP.

We think that this type of comparison of past and present debt/GNP ratios gives us an insight of crucial importance. The real underlying trouble is that compared with the past, credit needs or credit demand have jumped far out of proportion with economic activity. Similar to a narcotic, ever larger doses of credit and debt are required to keep the U.S. economy growing.

That brings us back to the supposed credit squeeze which has been capturing everyone's



attention. Apparently, it is the one and only explanation given for the progressive weakening of the economy.

To be quite frank, we have a lot of problems with the whole argumentation of a credit crunch. It starts with the question of how you measure either a credit crunch or a squeeze. What is too much credit and what is too little? What level is sound and what is unsound?

For the sake of illustration, we ask the reader to view the two facing charts. While they seem to differ diametrically, they portray one and the same thing although from different perspectives. The first chart shows the well-publicized picture of the U.S. credit expansion which, measured in annual growth rates, has virtually collapsed. The second chart shows the same credit expansion in terms of annual increases in outstanding debt. Simply put, the two charts show the difference between percentages and absolute increases.

Our simple point is that the picture of the stalling credit growth rate in the United States gives a very misleading impression. The reality is that debt growth is accelerating in relation to weakening economic activity. What the collapsing growth rates in new credit reflect, is not shrinking credit flows but a rapid "basis effect" as a continuing high credit expansion becomes dwarfed in percentage terms due to the exponential rise in the basis of outstanding debt. The debt ratio is at a record high after all, as already pointed out.

Analyzing the Debt. The key question to ask under these circumstances is this: what are the causes and circumstances of this sharply increased dependence of the U.S. economy on credit?

During the 1980s, total U.S. non-financial debt grew from a level of \$3.9 trillion to \$9.8. But,

the fundamental calamity of this debt surge lies in the purposes for which the money was borrowed. Perhaps more than 90% of this debt boom went to finance consumption (both public and private) or was engaged in non-productive activities such as real estate and stock speculation.

Most of the debt incurred in the U.S during the 1980s has be consigned to the "deadweight" category - that meaning that these debts have no assets behind them that yield revenue for future debt service. In that case, debt service can only be met by new borrowing or alternatively, by cutting other spending.

It was Irving Fisher who, in the 1930s, developed the "debt deflation" theory explaining that over-indebtedness finally leads to collapsing real estate and securities prices. J. A. Schumpeter, however, pointed out that Fisher had missed the crucial aspect about over-indebtedness: unproductive loans. Quoting Schumpeter, (Business Cycles Volume I, p.147): *"In these cases there is no increase in productivity at all, and it is this fact and this fact alone which is responsible for a fall in prices, sometimes spelling disaster . . . The only conclusion that really follows is that the credit machine is so designed as to serve the improvement of the productive apparatus and to punish any other use."*

In short, America's main disease - and that goes for other countries as well - is compounding interest costs on a mountain of predominantly unproductive debt. It's a disease like cancer that begins slowly and then rapidly cumulates. After all, at prevailing interest rates of 10%, $1 dollar of debt automatically grows to an obligation of $2.68 within 10 years. For example, under the automatic pilot of compound interest, America's present non-financial indebtedness of roughly $10 trillion will balloon to $28.6 trillion by the year 2000 . . . and that, starkly, presumes no new credit at all.

Debts are light to carry as long as new credits exceed the financing of interest costs. Interest rates then would be simply capitalized. But over time, the soaring bill of compound interest is bound to catch up and overtake the flow of new credit: As more and more banks press their debtors for genuine interest payments and debt reduction in order to protect their liquidity and solvency, the day or reckoning for borrowers and bankers alike, arrives.

Why is all this happening now even though U.S. banks show excess reserves (indicating that they have the liquidity to expand their loans) and a recession has yet to fully grip the system? All prolonged credit expansions ultimately end in the same way regardless of the available bank reserves. It happens whenever banks, for one reason or another, begin to insist on proper debt service. Then, all of a sudden, illiquidity spreads like a brush fire.

In conclusion, what we see in the United States is neither tight money nor shrinking credit, but an illiquid overexpanded colossus of debt that has become ever dependent on ever increasing injections of new debt.

Once again, what then are the underlying causes of the U.S. economy's slow but progressive weakening? In our view, these causes have two dimensions both being the legacy of the past excesses.

The one set of causes - the long-term damaging effects of persistent over-consumption, under-saving and under-investment - retards the overall growth potential of the economy. Reduced capital formation impairs productivity and income growth.

The second set of causes are the delayed contractive effects of the debt excesses. Slowing income growth and falling business profits collide with the soaring bill of compounding interest. An increasing part of borrowing serves to pay interest on existing debt. This explains why runaway credit growth translates into less and less GNP growth.

Sooner or later, the illiquid debtors are forced to liquidate assets - that being mostly the collateral for the loans. The financial crisis enters its second, most critical phase: illiquidity spreads to the asset markets . . . mainly real estate. But debt liquidation by widespread asset sales becomes self-defeating because increasing selling pressure causes inflated collateral values to plummet thus making the debts bigger and bigger.

A CRISIS ENVIRONMENT

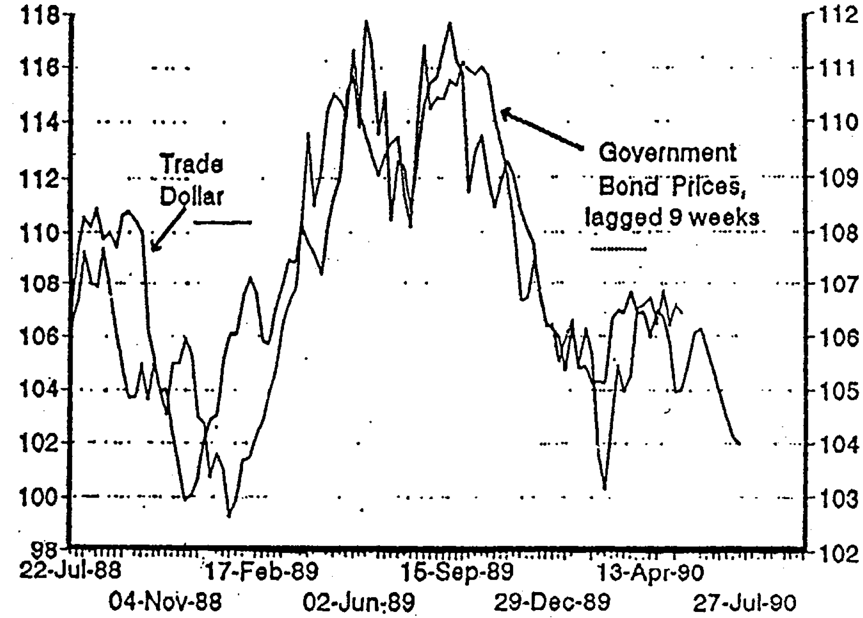
After more than seven years of nearly non-stop growth and after five years of unbridled speculation and borrowing by the government, businesses and consumers, the U.S. economy is finally approaching it final, critical turing point: a dramatic transition from boom to bust.

The bottom line is that the legacy of the past economic and financial excesses is worse than a simple cyclical recession. Many years of grossly insufficient savings and capital formation have ultimately left the economy on a path of dismal growth potential.

In theory, a country may manage to live with very low economic growth, but given America's exorbitant debt levels, consumers and businesses cannot simply adjust to lower growth. The huge debt build-up was premised on high-riding profit and income expectations. Therefore, any serious and sustained income shortfall is bound to exacerbate a recession with a debt crisis - and a bank crisis sooner or later. America cannot afford a debt and banking crisis. Its financial system has become too vulnerable to withstand all but the shortest and shallowest of recessions. There will come a point in the progression when the Fed will have to ease - and even aggressively at any price (rising inflation or sliding dollar) - in order to avoid an economic and financial collapse.

For America, the financial system is one Achilles heel and the exposed dollar is the other. As negatives surface, confidence in the dollar will rapidly wane and foreigners will either sell dollars or hedge their huge U.S. dollar investment and commercial exposures.

An additional negative for the dollar are comparative interest rates. The large U.S. trade deficit is no longer offset by a large positive yield differential against Germany and Japan. For the first time in more than 15 years, U.S. interest rates are lower than German interest rates. In fact, U.S. real interest rates are now the lowest in the world (see US/DM interest rate differential graph published in last letter).



Note: Bonds are lagged 9 months.
Source: Mark Mittelstaedt, Olympia Research and Management.

SUMMARY CONCLUSIONS

In our view, the U.S. dollar (and other related currencies) are destined for a steep fall. To this point, the tumble has only begun.

The Damocles sword hanging over the currencies of the dollar orbit are the huge foreign commercial and investment exposures. Given the generally strong confidence in the underlying strength of the dollar, these huge positions have generally been unhedged. But, increasing doubts in the dollar's stability are bound to trigger massive hedging operations. If that happens, the dollar will collapse with devastating effects for the U.S. bond market. The above graph shows the tight relationship recently between the dollar and government bonds.

In short, we can only say that it is potentially an explosive situation.

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